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Viewing cable 09MOSCOW2541, GAZPROM'S REVERSAL OF FORTUNE PART TWO; COMEBACK UNLIKELY

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Reference ID	Created	Released	Classification	Origin
09MOSCOW2541	2009-10-07 13:42	2011-08-30 01:44	CONFIDENTIAL	Embassy Moscow

Appears in these articles:
http://www.mcclatchydc.com/2011/05/16/114269/wikileaks-cables-show-oil-a-major.html

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VZCZCXRO4339
PP RUEHDBU RUEHFL RUEHKW RUEHLA RUEHNP RUEHROV RUEHSL RUEHSR
DE RUEHMO #2541/01 2801342
ZNY CCCCC ZZH
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RUEHXD/MOSCOW POLITICAL COLLECTIVE PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 04 MOSCOW 002541

SIPDIS

DEPT FOR EUR/RUS, EEB/ESC/IEC GALLOGLY AND GREENSTEIN,
S/EEE MORNINGSTAR
DOE FOR HEGBURG, EKIMOFF
DOC FOR JBROUGHER
NSC FOR MMCFAUL

E.O. 12958: DECL: 10/06/2019
TAGS: EPET ENRG ECON PREL RS
SUBJECT: GAZPROM'S REVERSAL OF FORTUNE PART TWO; COMEBACK UNLIKELY
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REF: A. MOSCOW 2528
¶B. VLADIVOSTOK 110
¶C. MOSCOW 854

Classified By: Ambassador John R. Beyrle for Reasons 1.4 (b/d)

¶1. (U) This is part two of a two-part cable on the new economic realities facing Gazprom, Russia's state-owned gas sector giant.

Summary

¶2. (C) Gazprom faces many external and internal constraints to renewed growth, following a dismal year in which all main indicators of its performance deteriorated dramatically. The globalizing gas market, a gas glut that shows no signs of reversal, and politicized management likely mean that Gazprom will not reach the heights of revenues and power achieved at its peak in 2008. Unfortunately, the types of reforms (e.g. privatization) that would result in a more valuable and productive gas industry are stymied by the GOR's seemingly firm belief in a state-controlled sector. While Gazprom will remain a major economic force, its influence on GOR policy and its relative role in the Russian economy likely will diminish in the short- and medium-term. End summary.

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external constraints to a rebound

¶3. (SBU) Gazprom's current problems (ref A) are not solely the result of one-off contractions in demand due to the economic crisis. Gazprom faces a fundamental shift in the gas demand picture at a time of increasing competition.

Demand stabilization and decline --

¶4. (SBU) xxxxxxxxxxxx told us recently that Gazprom was simply unprepared for the inevitable leveling off and current decline in European gas demand. He explained that Gazprom's management has only known rapidly rising European demand for Russian gas as most European countries "gassified" their economies over the past two decades. He noted that anyone looking at the trend could have been excused for thinking it would continue perpetually; but now the period of gassification is over. According to xxxxxxxxxxxx demand for gas in Germany is actually in decline, as industrial production in Germany (and across Europe) has become more efficient and as much of it has been outsourced.

Competition --

¶5. (SBU) Gazprom not only faces a demand problem, but also competition from an increasingly globalized gas market -- "for the next 5 to 10 years, gas will clearly be a buyers market," said xxxxxxxxxxxx has calculated (using data from the BP Statistical Review of World Energy) that Gazprom's share of EU 27 gas imports has dropped steadily from about 50% in the mid-90s (when gassification increased demand) to just 34% in 2009. xxxxxxxxxxxx expects Gazprom's share to decline to about 30% and stabilize at that level. xxxxxxxxxxxx also calculated that LNG's contribution to EU imports over the last decade has increased from about 10% to about 20%, a figure he projected to continue to grow. In addition, Gazprom will have to cope with massive new volumes of LNG on the global market from projects already underway in Qatar and elsewhere (ref C).

No help from other markets --

¶6. (C) Gazprom is unlikely to get any relief from its former Soviet Union(FSU) customers either. Despite the likely rise to "market prices" for gas sales to the FSU, lower demand will continue to hurt Gazprom. Ukraine, Gazprom's major export market outside of non-FSU Europe, earlier signed a

take-or-pay contract which outlines a minimum amount of gas which Ukraine is obliged to purchase from Russia. Ukraine

has recently indicated it might take as little as 50% of the 52 bcm of gas it had earlier agreed to buy in 2010. Russian government officials remain concerned over Ukraine's ability to pay for gas this winter and are already signaling they are prepared to shut off exports to Ukraine in the event of non-payment.

¶7. (SBU) Global markets will also offer little hope for Gazprom, at least in the medium-term. Gazprom executives have often expressed the expectation that the company would become a global gas supplier, perhaps through newly expanded LNG capacity. However, their preferred future export destination, the U.S., is looking more and more saturated every day with ever larger estimates for domestic production. In a recent meeting with Embassy officials in Sakhalin, Shell oil representatives stated that no LNG had been shipped from the Sakhalin II facility to the U.S. due to soft prices in that market. Much of this LNG has been shipped to Japan instead.

Domestic market --

¶8. (SBU) Gazprom often touts future revenue gains from domestic market price liberalization. However, it neglects to account for demand elasticity in the wake of sharp proposed increases in prices. With one of the most energy intensive economies in the world, future hikes in domestic gas prices would likely cut domestic demand substantially, as evidenced in other countries that have implemented rational pricing. Thus Gazprom's revenue gains from higher domestic prices would be at least partly offset by lower sales volumes.

External politics --

¶9. (SBU) In addition to the headwinds from market forces, Gazprom faces the political and PR difficulties in external markets that it has largely brought on itself through the gas cutoffs of 2009 and 2006. Despite some pain in certain Central and Eastern European countries, Ovchinnikov explained, the 2009 gas cutoff showed that Europe could get by without Russian gas. This should bolster EU determination to minimize its dependence on Russian gas, and to explore new options to diversify energy supplies.

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internal constraints to growth

The Ministry of Gas --

¶10. (SBU) A Gazprom that behaved more like a competitive global company would probably find a new path to growth more quickly. But Gazprom is not a competitive global company, despite sitting on the world's largest gas reserves. Gazprom is a legacy of the old Soviet Ministry of Gas and it still operates much the same way. As a Gazprom executive himself admitted to us, the company's first two priorities are to provide reliable and affordable gas to the domestic population, to "fulfill its social obligations." One contact with direct information told us it took a senior partner from a major accounting firm two years of full-time investigation just to unravel Gazprom's holdings, which include one of Russia's largest banks, one of Russia's major media companies, and a major construction company.

Technologically backward --

¶11. (SBU) Gazprom's legacy and the government's ownership of the company also mean that it must act in the interests of its political masters, even at the expense of sound economic decision-making. From building unneeded pipelines (ref B) to maintaining employment at some unneeded facilities, Gazprom

declines to solely act on financial and economic grounds. As a state-controlled monopoly during the flush times of the past decade, Gazprom had little incentive to develop new technologies and capabilities long enjoyed by other global oil and gas companies. Despite management's interest in expanding Gazprom's LNG capacity, the company has only one LNG export terminal, which it took over by forcibly becoming the majority owner in a Shell-led consortium. Rapid

expansion of LNG export capacity is unlikely without the help of international oil companies (IOCs), who are still trying to find an acceptable future working model in Russia.

Inability to adapt --

¶12. (SBU) Gazprom's inability to meet competitive pressures is apparent in the current European gas market. According to xxxxxxxxxxxx Gazprom is the only major European supplier that has had to cut production. xxxxxxxxxxxx blames Gazprom's "self inflicting wound" of tying gas prices to oil prices. He said this convention dates back to when gas was a substitute for fuel oil for heating. xxxxxxxxxxxx explained that this oil price link has made Gazprom the high-price supplier in Europe, a situation that is likely to continue into the near future. xxxxxxxxxxxx said that with European gas demand unlikely to recover to pre-crisis levels until 2013 and Europe facing "excess supply" for at least the next decade, Gazprom will have a very tough time just maintaining market share. A major oil company senior executive echoed this analysis in a recent meeting with us, noting "if you are a European consumer, the last molecule of gas you want to buy is from Gazprom."

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possible tensions, but reforms unlikely

¶13. (SBU) The tough times may be creating (or exacerbating) tensions within Gazprom and the GOR over the company's future. Several contacts have told us they have heard of such tensions. One Russian company executive said he has heard that xxxxxxxxxxxx has been pushing for dismantling Gazprom, to at least take away its control over the domestic gas pipeline system. An executive at a Western company told us recently that there are two camps within the upper levels of the GOR on the issue of Gazprom's direction. One camp favors the current "one national company" approach, while the other favors competition to spur a more efficient and modern gas sector. Unfortunately, this executive explained, "the number one factor" in managing Gazprom from the GOR perspective is "how to increase government revenues from the company."

¶14. (C) xxxxxxxxxxxx, brushed off rumors of infighting at Gazprom as nothing new. xxxxxxxxxxxx said there has always been infighting at the company because it is such a bureaucratic behemoth. "Everyone is always looking to make others look bad in order to move ahead themselves," xxxxxxxxxxxx said. While xxxxxxxxxxxx acknowledged Gazprom's substantial problems, xxxxxxxxxxxx did not think any major reforms would be forthcoming.

¶15. (SBU) Rumors aside, nobody with whom we have talked believes Gazprom is in any danger of losing its monopoly on exports or its preferred status within the Russian economy. Nor is the government likely to give up control of the company anytime soon. Without such fundamental reforms, it is difficult to see how Gazprom can transform itself into a modern corporation in the current environment.

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comment

¶16. (C) Gazprom is what one would expect of a state-owned monopoly sitting atop huge wealth -- inefficient, politically

driven, and corrupt. For years, with its exports and export prices rising rapidly, it could easily pretend that all was well and that the future was bright. That pretense may now be giving way to the new reality of declining sales, lost market share, and an inability to maneuver adeptly in the face of global competition. Although Gazprom will likely muddle along as a major corporation and major contributor of jobs and budget funds, its economic contribution will likely be diminished. While Gazprom can still shut off gas to Ukraine or to other parts of Europe, each such threat further undermines the company's credibility as a reliable energy supplier, and underscores the fact that Gazprom is

politically subordinate to the Kremlin. Gazprom's influence, both domestic and international, has been directly tied to its cash flow -- money that funds employment, suppliers, budgets, charities, foreign ventures, and, surely, many private bank accounts and dirty deals. Unfortunately for Gazprom and for the GOR, the massive revenues and profits that the company produced in 2008 are unlikely to return anytime soon. End comment.
Beyrle